No. 11818.

IN THE

# United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

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Annis Van Nuys Schweppe,

*Petitioner,*

*vs.*

Commissioner of Internal Revenue,

*Respondent.*

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**Upon Petition to Review a Decision of the Tax Court of the United States.**

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## APPELLANT'S OPENING BRIEF.

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## APPELLANT'S OPENING BRIEF.

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### Jurisdictional Pleadings and Facts.

This case originated with the filing by the petitioner, Appellant herein, in the United States Tax Court of a petition for a redetermination of the deficiency in her Federal Income Tax for the calendar years 1940 and 1941 set forth by the Commissioner of Internal Revenue, Respondent herein, in a Notice of Deficiency dated August 10, 1944. [R. 4.] This petition was properly filed pursuant to the provisions of Section 272 of the Internal Revenue Code. The Tax Court accepted jurisdiction pursuant to the powers granting it in Section 1101 of the Internal Revenue Code and the statutory provisions therein incorporated by reference, and disposed of the matter by rendering an opinion [R. 19] and decision [R. 36] adverse to the Petitioner.

In due course the Appellant filed a petition for review by this Circuit Court of the aforesaid adverse decision of the Tax Court of the United States [R. 37], and this Court has jurisdiction to consider the matter on appeal pursuant to Section 1141(a) of the Internal Revenue Code.

## Statement of the Case.

During the tax years here involved the Appellant as a stockholder in the I. N. Van Nuys Building Company received cash distributions from said Company with respect to her stock in amounts totaling $35,246.38 for the calendar year 1940 and $24,194.16 for the calendar year 1941. It is conceded that of these amounts $10,746.62 for the year 1940 and $3,128.02 for the year 1941 were paid out of the "earnings or profits" of said Company, and are taxable as dividends under Section 115(a) of the Internal Revenue Code. The Commissioner contends that the balance of such distributions was likewise paid out of earnings or profits accumulated since March 1, 1913, and, is, therefore, taxable as a dividend in each of the years involved, whereas, the Appellant claims that there were no further earnings or profits available to cover said balance, and that, therefore, it is not taxable as a dividend, but should be applied in reduction of the basis of her stock in said Company.

The issue thus raised depends on whether or not an increase in the net assets of said Company in the amount of $400,000, resulting from the elimination as a liability

of the Company of an original indebtedness of that amount to Susanna H. Van Nuys, taxpayer's mother, constitutes "earnings or profits" of said Company. The circumstances surrounding this transaction are not in dispute; they were settled largely by Stipulation in the trial in the Tax Court and it has set them forth fully in its Findings of Fact to which no exception is taken.

The I. N. Van Nuys Building Company was incorporated February 15, 1911, under the laws of the State of California. Most of its original outstanding stock was owned by I. N. Van Nuys, the husband of Susanna H. Van Nuys and the father of the Appellant. The remaining original outstanding stock was owned by Appellant's mother, Appellant, her sister and her brother. [R. 52.] I. N. Van Nuys died February 12, 1912, bequeathing one-half of his stock in said Company to his widow Susanna H. Van Nuys and one-sixth to each of the aforementioned three children. [R. 21.]

The Company owned real property at the Southwest corner of Seventh and Spring Streets in Los Angeles, California, and during the years 1912 and 1913 constructed an office building upon this tract. During the course of construction Susanna H. Van Nuys loaned to the Company the sum of $400,000, which loan was evidenced by a promissory note dated March 1, 1913, payable three years after its date, with interest at 5% per annum. This note was secured by a mortgage dated March 1, 1913, on said real property which was never recorded. At the time of this loan the stock in the Com-

pany was owned approximately one-half by Susanna H. Van Nuys and one-sixth by each of her three children, one of whom was the Appellant.

Nothing was done concerning the payment or extension of this note when it matured in 1916 nor thereafter, and at various times between 1915 and 1920 Susanna H. Van Nuys told her children that she never intended to enforce collection of the note. In 1919 she gave them all of her stock in the Building Company except one share (which she held until her death), and they, or their immediate families, have owned all of its outstanding stock except this share and one other share ever since.

In May, 1923, Susanna H. Van Nuys died still possessing the note and leaving a Will which mentioned specifically many assets but made no mention of the note. The semi-annual interest installment on said note for December, 1922, was paid, but no interest thereon was paid after that date. When the question was raised regarding the taxability of the note as an asset in the estate of Susanna H. Van Nuys, upon advice of Tax Counsel [R. 102, 103] a friendly action was brought by her Executor against the Company on the note on October 28, 1925. The Company successfully pleaded the Statute of Limitations and secured judgment on November 6, 1925. Thereafter, the matter was litigated in a Federal Court proceeding involving the estate tax liability of the Estate of Susanna H. Van Nuys, in the case of *Title Insurance and Trust Company v. Welch*, 37 F. (2d) 617 (S. D. Cal., 1927), and it was ultimately held that the note

should not be included in the Estate at any value since the Statute of Limitations had run thereon prior to death and it had no value at death. The Federal case decided the issue of the Statute of Limitations upon its merits and specifically refused to accept the previous State Court decision as *res adjudicata*.

Meanwhile on January 21, 1924, long prior to the commencement of the suit to enforce the note, and, of course, prior to the Estate Tax controversy, the Company by appropriate Board action [R. 84] eliminated its liability on the note and transferred the amount to "Surplus paid in." Matters stood thus until 1938, when the Building Company, by appropriate action, first increased its stated capital by $400,000, thus eliminating the surplus paid in, then reduced the stated capital by $400,000, thus creating a reduction surplus account in the amount of $400,000, which, pursuant to the California Corporation law, could then be distributed to the stockholders. The distributions in 1940 and 1941 which are at issue in the present litigation were made from this reduction surplus account.

The Tax Court held that the elimination of the $400,000 indebtedness increased the earnings and profits of the Company by that amount, and it followed from such a holding that there were sufficient earnings and profits to cover the entire cash distributions received by Appellant from the Company during the years here in question, 1940 and 1941. Consequently, they were taxed in their entirety as dividend income under Section 115(a) of the Internal Revenue Code.

## Specification of Errors.

The Appellant assigns as error, the following Conclusions of Law of the Tax Court:

1. The finding that the entire distributions received by petitioner from the aforesaid Company in 1940 and 1941 constituted dividend income.

2. The finding that the earnings or profits of said Company properly allocable to the distributions to the petitioner for the year 1940 exceeded $10,746.62, and for the year 1941 exceeded $3,128.02.

3. The finding that the elimination of the aforesaid $400,000 indebtedness by said Company increased its earnings or profits by $400,000.

4. The finding of deficiencies for the years 1940 and 1941 in the respective amounts of $10,110.70 and $14,-850 in lieu of a determination that the deficiencies for said years should be respectively $750.88 and $4.500.15.

## Summary of Appellant's Argument.

A—The increase in the net assets of the I. N. Van Nuys Building Company resulting from the elimination of the $400,000 indebtedness did not result in any increase in "its earnings or profits accumulated after February 28, 1913," and does not, therefore, constitute a source from which dividends under Section 115(a) may be paid.

(1) Congress has specifically limited the source from which dividends can be paid to "earnings or profits accumulated." Therefore, the ultimate legal issue is whether or not the item here in question is properly so characterized; the issues of whether or not there was a forgiveness of the indebtedness, whether or not there was a contribution to capital, or whether or not there was a gift are merely subsidiary issues of assistance in determining the ultimate legal issue.

(2) An increase in the net assets of a corporation resulting from a gratuity does not constitute "earnings or profits accumulated," as that phrase is used in Section 115(a) of the Internal Revenue Code.

(3) The $400,000 increase in the net assets of the I. N. Van Nuys Building Company was gratuitous, not only because the Company furnished no consideration therefor, but also because said increase resulted from the gratuitous intent of Susanna H. Van Nuys toward the Company and its stockholders, her children, and her purposeful inaction to effectuate that intent.

(4) In Tax matters, the law is concerned with the substance of a transaction, and the chain of events which resulted in the $400,000 increase in the net assets of the Company amounted in substance to a contribution of that amount to the capital of said Company either by Susanna H. Van Nuys or her three children.

(5) Contributions to the capital of a corporation do not constitute "earnings or profits accumulated."

B—In determining that the increase in the net assets of the I. N. Van Nuys Building Company under the instant circumstances constituted "earnings or profits accumulated" the Tax Court committed a clear error of law which it is the duty of this Court to correct under Section 1141(c)(1) of the Internal Revenue Code.

## ARGUMENT.

### The Increase in the Net Assets of the I. N. Van Nuys Building Company Resulting From the Elimination of the $400,000 Indebtedness Did Not Result in Any Increase in "Its Earnings or Profits Accumulated After February 28, 1913," and Does Not, Therefore, Constitute a Source From Which Dividends Under Section 115(a) May Be Paid.

#### Congress Has Specifically Limited the Source From Which Dividends Can Be Paid to "Earnings or Profits Accumulated." Therefore, the Ultimate Legal Issue Is Whether or Not the Item Here in Question Is Properly so Characterized; the Issues of Whether or Not There Was a Forgiveness of the Indebtedness, Whether or Not There Was a Contribution to Capital, or Whether or Not There Was a Gift Are Merely Subsidiary Issues of Assistance in Determining the Ultimate Legal Issue.

The only time when a corporate distribution is taxable as a dividend is when the Tax Statute says it is. The surprisingly simple answer to the present problem is that the Tax Statute does not say that the distribution here involved is a dividend.

Section 115 of the Internal Revenue Code in effect for the tax year here in question provided in sub-sections (a) and (d) as follows:

> "(a) Definition of Dividend—The term 'dividend' when used in this chapter (except in section 201(c)(5), section 204(c)(11) and Section 207(a)(2) and (b)(3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumu-

lated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *"

* * * * * * * *

"(d) Other Distributions From Capital.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in Section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under sub-section (f)(1), is not treated as a dividend, whether or not otherwise a dividend."

The Respondent contends that portions of the 1940 and 1941 distributions at issue come within sub-section (a) above quoted, whereas, the Appellant claims that they fall within sub-section (d) above quoted. The Appellant thus relies upon the general "catch-all" provision, whereas, the Respondent relies upon the specific provision. Appellant's Counsel in the Tax Court rested Appellant's case on the proposition that there had been a gratuitous forgiveness of the indebtedness by Susanna H. Van Nuys during her lifetime which amounted to a contribution to the capital of the corporation. [R. 28, 33.] It is submitted that this was and is a sound position and that the

Tax Court committed a clear-cut error of law in holding otherwise. However, this is not the ultimate issue in the case. Under the above quoted provisions it is not the duty of the Appellant to prove what the questioned item constitutes; it is merely her duty to prove what it does *not* constitute, namely, "earnings or profits accumulated." Congress did not choose to provide that all corporate distributions except in liquidation or except out of capital should be dividends. Rather it reversed the phraseology and specifically limited dividends to distributions out of earnings or profits accumulated. This is the perspective in which the instant facts must be viewed.

To the ordinary man, it would come as something of a shock to be told that a tremendous increase in the net assets of a family corporation under the circumstances here involved would qualify as an "earning" or a "profit." These terms have a well accepted significance in business and legal channels as describing the favorable *results* of a corporation's *operations*. Can there be any question as to the reaction of the Securities and Exchange Commission to a Registration Statement filed by the I. N. Van Nuys Building Company in which it attempted to sell its stock upon the representation, accounting-wise, that this $400,000 was a part of its "earnings" or its "profits"? It is respectfully submitted that any such characterization would be grossly misleading and inaccurate, and would be summarily rejected by that body. It is precisely as misleading and inaccurate to characterize it thus for tax purposes.

Neither of the words "earnings" or "profits" embraces an *unearned* increase in net assets such as is involved in the instant case. And if we consider the words together so that the phrase itself "earnings or profits" has a single meaning, the conclusion must be the same, for then we are dealing with a well established concept of legal and corporate accounting. And we will show hereafter in this Brief that this concept is generally synonymous with the accounting phrase "earned surplus," which is the very antithesis of an *unearned* increase in net assets.

Furthermore, we cannot overlook the important word "accumulated" as used in the statute. This connotes a recurrent stream of receipts or a building up over the years, rather than in isolated single benefit, such as is involved in the instant case. One never hears the phrase "accumulated capital," "accumulated capital surplus" or "accumulated donated surplus." But the phrases "accumulated earnings" and "accumulated profits" are common ones, simply because the terms "earnings" and "profits" refer to returns from operations, which operations proceed in a rather constant manner. Certainly a $400,000 increase in net assets such as is involved in the instant case is not the type of increase that is "accumulated." It bears a much closer resemblance to capital which is originally "paid in" than it does to earnings or profits which normally accrue in a steady stream.

The non-recurring character of an item, while not in itself conclusive, has an important bearing on its proper characterization for tax purposes:

*Magill,* "Taxable Income" (1945), Chapter II, Gifts and Bequests, p. 407:

> "Probably the usually applied judicial test—the common understanding of the term income—would lead to an exemption in the case of single, non-recurrent gifts, having no element of compensation. The absence of the *quid pro quo* that is generally associated with income; the infrequency with which they occur, as contrasted with the steady recurrence of most items of income, are responsible for this conclusion. On the other hand, the presence of either of these latter factors might lead to a different result, for reasons which will be discussed hereafter."

It is submitted, therefore, that simply upon a consideration of the clear language of the Statute, there can be no question but that the item here involved does not fall within the statutory phrase "earnings or profits accumulated." However, the Tax Court treated this ultimate issue in a rather cursory manner in the last page of its opinion and spent the rest of its time discussing subsidiary issues such as whether or not there had been a gratuitous forgiveness of the indebtedness, and whether or not there had been a contribution to capital. In the following portions of this Brief we will meet the Tax Court on its own ground and prove that by applying each of its subsidiary tests we arrive at the same answer, namely, that the increase in net assets here involved does not fall within the phrase "earnings or profits accumulated."

**An Increase in the Net Assets of a Corporation Resulting From a Gratuity Does Not Constitute "Earnings or Profits Accumulated," as That Phrase Is Used in Section 115(a) of the Internal Revenue Code.**

There is apparently no case directly in point on the proposition advanced in the foregoing heading. This is undoubtedly due to the following two reasons:

(1) A gift to a corporation is usually made by a stockholder, and the Commissioner, in his own regulations, as well as the Courts have treated such gifts as "contributions to capital." Since "capital" is the very antithesis of "earnings or profits" such contribution could not possibly qualify under the latter phrase.

(2) The Congressional language, "earnings or profits" clearly indicates "gain derived from capital or labor or both" (classic definition of income in *Stratton's Independence, Ltd. v. Howbert,* 231 U. S. 399, at 415, 58 L. Ed. 285, 34 Sup. Ct. 136 (1913)), that is, a *return* rather than a mere *receipt*. Thus, the proposition of the above heading has been taken for granted, just as it was in that part of the Tax Court's opinion in the instant case which attempted to distinguish the present facts from the Gift involved in the *American Dental* case.

The original 1913 Revenue Act, Public Law 16, 63rd Congress, 38 Stat. 166, used the word "profits" on several occasions. The definition of a dividend as a distribution out of "earnings or profits accrued" was introduced into the Tax Law by the Revenue Act of 1916, Public Law 271, 64th Congress, 42 Stat. 227, Title I, Part 1, Section 2(a). Consequently, it is important to determine the meaning of these words and this phrase at this early period in the history of our Federal Income Tax Statute.

The following pertinent definitions appeared in the 1911 edition of the "Comprehensive Standard Dictionary" published by Funk & Wagnall.

> "earning—That which is earned; compensation; wages; commonly in the plural.
>
> profit—1. Any accession of good from labor or exertion; benefit; return. 2. Excess of returns over outlay."

Definitions of these same phrases from 1921 and 1946 editions are similar. While they are somewhat more detailed than the above definition, there is absolutely no change in the fundamental concept that an earning or profit is a *return* from capital or labor rather than a mere *receipt*. The word "profit" used alone in a non-business sense at times has a broad meaning which encompasses any benefit, so that both in the 1911 definition and the subsequent definitions there is included in a subsidiary sense this broad meaning. However, there is no question but that when the term is used in a corporate or business sense, it contemplates clearly a return from the use or disposition of capital or labor, that is, something received in exchange for something furnished, and could not possibly include a gratuitious receipt.

In the 1912-1913 Year Book of the American Association of Public Accounts (the predecessor organization of the American Institute of Accountants), published by the Ronald Press of New York, there is contained at page 176 a report of the Association's Committee on Accounting Terminology. This Report contained a comprehen-

sive definition of various accounting terms and therein the terms "profits" and "earnings" were defined as follows:

> "Profits—Profit consists of the surplus remaining over from the employment of capital after defraying all the necessary expenses and outlay incurred in its employment, and after the capital has been replaced or provision made for its replacement" (p. 216).
>
> "Earnings and Income Account—shows the amount of money earned as payment for services, and revenue, and interest from investments—against which the corresponding expense and outlay charges are made" (p. 196).

It will be noted that a "profit" is defined as a surplus resulting from the "employment of capital," the very antithesis of a donation, which has no connection with the employment of capital. Likewise, the term "earnings" is defined as "revenue," "payment for services earned." This definition clearly does not contemplate a donative contribution which is in no sense earned. The very word "earning" of itself and in itself excludes such amounts.

It is equally clear from the authoritative definitions of this same accounting body that gifts and donations should properly be reported as "special surplus" rather than "earned surplus." The 1912-1913 Year Book refers back to the Association's Year Book of 1911 containing a complete discussion of surplus. At page 124 thereof appears the following:

> "When any classification of surplus is shown in the statement, the form conveying the most information is (a) 'Surplus, representing accumulated undivided profits remaining at the end of the fiscal year;

> (b) Profits and Loss, representing the net profit for the current fiscal year; and (c) Special Surplus, surplus created from other sources."

Clearly a donation would fall in this latter type of surplus.

This question as to classification of surplus was treated in detail by C. B. Couchman in an article entitled "Classification of Surplus," Volume 32 of the Journal of Accountancy, October 1921. This paper was read at the annual meeting of the American Institute of Accountants, September, 1921, and was reprinted in "The Accountant," the official organ of the Society of Chartered Accountants in England. At page 266 of the Journal of Accountancy it was stated:

> "It is desirable that accounting reports shall so classify and describe corporate surplus that its source may be readily determinable.
>
> * * * * * * * *
>
> Surplus may come from four sources:
>
> 1. From contributions by the proprietorship.
>
> 2. From gifts, awards or contributions from others than proprietors where no corresponding service of value is rendered or liability created. * * *
>
> 3. From the sale of capital assets.
>
> 4. From profits or income earned in the operations of the business."

There can be no question that the item involved in the present case would not fall in Class 4 above, which is undoubtedly the class of surplus Congress had in mind when it used, rather than the broader word "surplus," the phrase "earnings or profits." And there can be no ques-

tion but that the action of the I. N. Van Nuys Building Company in 1924 in crediting the amount of the debt eliminated to "Paid-in Surplus" rather than "Earned Surplus" was a natural and true accounting reflection of it. This is important because, generally, the phrase "earnings or profits" as used in an income tax statute is considered to be synonomous with the general concept of "*earned* surplus" in accounting circles.

> *Flint v. Commissioner of Corporations and Taxation,* 312 Mass. 204, 43 N. E. (2d) 789 at 791 (1942);
>
> *Commissioner of Corporations and Taxation v. Filoon,* 310 Mass. 374, 38 N. E. (2d) 693 (1941), at 700 (so holding even as to the broader phrase "accumulated profits").

> "The surplus of a corporation may be 'earned surplus' as where it was derived wholly from undistributed profits."
>
> *Winkelman v. General Motors Corporation,* 44 Fed. Supp. 960, 996 (D. C., N. Y., 1942).

In *Edwards v. Douglas,* 269 U. S. 204, 70 L. Ed. 235, 46 Sup. Ct. 85 (1925), an Estate received during 1917 a substantial dividend. Since the law then in effect taxed this dividend at the rates in effect for the years in which the "profits or surplus" from which the dividend was paid were accumulated, it was claimed that these dividends were taxable at the 1916 rate. This argument was based upon the proposition that even though the corporation had current earnings in 1917 when the dividend was paid, there could be no profits or surplus accumulated until the close of an accounting period, and, therefore, the entire distribution must be charged to 1916 earning. In

holding that the dividend should be taxed at the 1917 rate Justice Brandeis, relying upon many accounting definitions, including those contained in the Committee on Accounting terminology of the American Association of Public Accountants Year Book of 1913, the same reference as is discussed above, said (p. 214):

> "Congress did not use the words 'surplus account' or 'undivided profits account.' Its language is 'undivided profits or surplus.' The word 'surplus' is a term commonly employed in corporate finance and accounting to designate an account on corporate books. But this is not true of the words 'undivided profits.' The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock. This surplus may be 'paid-in surplus,' as where the stock is issued at a price above par. It may be 'earned surplus,' as where it was derived wholly from undistributed profits. Or it may, among other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property. See *La Belle Iron Works v. United States,* 256 U. S. 377, 385, 65 L. ed. 998, 1005, 41 Sup. Ct. Rept. 528. As used in Section 31(b) the terms undoubtedly means that part of the surplus which was derived from profits which, at the close of earlier annual accounting periods, were carried into the surplus account as undistributed profits. On the other hand, the term 'undivided profits' has not acquired in corporate finance and accounting a like fixed meaning. It is not known as designating generally in business an account on the corporation's books, as distinguished from profits actually earned but not yet distributed. Few business corporations establish an 'undivided profits' account. By most corporations

> the term 'undivided profits' is employed to describe profits which have neither been distributed as dividends nor carried to surplus account upon the closing of the books; that is, current undistributed earnings."

It will be noted from the above quotation that the Court recognized many types of surplus, specifying several "among others," and that "earned surplus" is derived "wholly from undistributed profits," which in turn is synonomous with "current undistributed earnings." This statement is important not only as indicating that the phrase "earnings or profits" is synonomous with "earned surplus," which embraces only "earnings," generally, but, also as proving that the tax law recognizes several kinds of surplus. Since the increase in assets involved in the present case would not properly fall within "earned surplus" it would not constitute a source from which dividends could be paid.

Under the above authorities, certainly a well accepted accounting principle for determining earned surplus should be controlling in determining earnings and profits unless the purpose of the Tax law requires otherwise. There is nothing in the purpose or legislative history of the tax law indicating that these words or this phrase should have a meaning different than its ordinary and well accepted accounting meaning. On the contrary, the view that a gift is not included in the phrase "earnings or profits" is in complete harmony with the purpose and legislative history of the law.

Finally, one of the recognized authorities on income taxation has discussed this point in detail and has concluded that a gift should not be included in earnings and profits. *Paul,* "Selected Studies in Federal Taxation,"

2nd Series 1938, pages 164, 165, 51 Harv. L. Rev. at 50, 51.

"It is hard to see how, by definition, a gift could be 'earnings or profits.' It has been previously noted in criticism of the dictum in the Cummings case: 'A gift may increase surplus, but according to common parlance a gift has not been earned, and by definition there is in a gift no element of profit.'

A long line of cases starting with *Edwards v. Cuba R. R. Co.,* have established the rule that gifts and capital contributions are not income within the meaning of the Sixteenth Amendment. The mere fact that there is consideration for the payment in the form of duties imposed on the accepting corporation does not alter the principle stated. What is controlling is the absence of obligation to make the gift; it is irrelevant that the 'donor' may receive incidental benefits.

But we need not enter the realm of speculation as to whether it would be possible to impose a tax on dividends from any source whatever other than capital invested. The constitutional metaphysics involved have little bearing on the meaning of the words 'earnings or profits' used in the Act; at any rate, the true question is whether a gratuitous contribution is intended by Congress to be included in the term 'earnings or profits.'

Even though a gift to a corporation should not be income in the constitutional sense, it might become the source of a taxable dividend. The real problem is one of statutory construction. The statutory concept of 'earnings or profits' is undoubtedly wider in scope in some respects than the statutory or constitutional concept of 'net income.' It may also in other respects be narrower, and is narrower, in the opinion of the author, in the case of gifts."

**The $400,000 Increase in the Net Assets of the I. N. Van Nuys Building Company Was Gratuitous, Not Only Because the Company Furnished No Consideration Therefor, but Also Because Said Increase Resulted From the Gratuitous Intent of Susanna H. Van Nuys Toward the Company and Its Stockholders, Her Children, and Her Purposeful Inaction to Effectuate That Intent.**

The I. N. Van Nuys Building Company received $400,000 from Appellant's mother in 1913, which it used in the construction of the office building. It paid 5% per annum for the use of this money through December, 1922. Thereafter, it paid no further interest. In January, 1924, it eliminated its obligation on the note and credited surplus paid in with the entire $400,000. Its action in so dong was subsequently verified by two court judgments to the effect that the note had outlawed on March 1, 1920. It is obvious, therefore, that this Company furnished no consideration in return for the elimination of this indebtedness.

The Tax Court opinion concludes that the increase in the net assets of the Company was not gratuitous because it resulted from its successful litigation in the Los Angeles Superior Court in which it raised the defense of the Statute of Limitations. The Company's part in this litigation consisted in filing a three page answer on October 30, 1925, in which it set up the defense of the Statute of Limitations. [R. 70.] It may also have participated in the trial on November 4, 1925, and assisted in the preparation of Findings and Judgment rendered on November 6, 1925. It is important to note that this action was commenced on October 28th and was finally decided by judgment nine days later. [R. 59, 80.] What clearer

proof could be asked that this was a friendly suit in which the parts of the opposing parties were in no sense adversary? In view of these facts it is the baldest sort of fiction to claim that such litigation was the generating force behind the acquisition of $400,000 through the elimination of a $400,000 indebtedness.

This litigation was not only friendly but was completely abortive. It had no effect whatsoever on the estate tax liability of Appellant's mother's estate. This is perfectly apparent from the opinion of Judge McCormick in the Estate Tax case which followed the litigation in the Los Angeles Superior Court. In holding in favor of the taxpayer, the Court there said:

> "It is proper to state that I have not reached this conclusion upon any theory of the application of the doctrine of *res judicata* by reason of the judgment of the state court wherein the note and mortgage were decreed to be legally unenforceable obligations and pecuniarily worthless. I do not believe that the doctrine of *res judicata* can be applied in this case as against the United States or its collector of internal revenue. The parties to the two causes are different. The United States does not stand in privity with any party in the state court action. However, we should consider the record evidence of the state court action on the question as to the market value and money worth of the note at the itme of Mrs. Van Nuys' death, to wit, May 1, 1923.
>
> "Considering all the evidence, I am persuaded by it to give the taxpayer the benefit of the doubt that exists in my mind as to the taxable value of the note. I do not believe that the interest payment checks in evidence constitute *ex proprio vigore* such direct and unqualified admissions of indebtedness by the maker

of the note, and show a clear acknowledgment of its willingness to pay the note indebtedness so as to remove the bar on the statute of limitations that had already run against the note and the debt that it evidences. See Clunin v. First Federal Trust Co., 189 Cal. 248, 207 P. 1009. This uncertainty, coupled with the direct evidence in the record as to the worthlessness of the note, leads me to conclude that it should not be taxed in the estate of Mrs. Van Nuys."

*Title Insurance and Trust Company v. Welch*, 37 F. (2d) 617 (S. D. Cal. 1927).

Thus, the litigation which was originated for the sole purpose of verifying for estate tax purposes the conclusion that the note had outlawed [R. 102, 103] did not even accomplish that purpose. And it could be of no significance for any other purpose because prior to its commencement the Corporation had taken its position by ceasing to pay interest and by eliminating the indebtedness and crediting paid-in surplus. Furthermore, both the entire ownership of the Corporation and the entire ownership of the residuary estate of Susanna H. Van Nuys, into which the note as an asset would fall, were in her three children in practically identical proportions.

It is clearly settled as a matter of Tax law, even in connection with *bona fide* adversary litigation, that such litigation does not alter the tax character of the right involved or receipt obtained. Litigation does not create rights; it adjudicates rights and obligations which have arisen from the occurrence of facts prior to litigation. Thus, in tax matters if the right litigated is a capital item any recovery thereon must be reflected as such whether or not litigation is necessary; and if it is an income item, it must be reflected as such. This is so ele-

mental as to require no extended citation of authority. One close analogy will suffice. This is furnished by the cases incolving the tax character of a recovery of a claimed heir under a Will Contest or similar heirship litigation. In such a situation the heir, or asserted heir, makes the legal claim and in certain instances prosecutes it in the courts, thus expending considerable time and money in so doing. If he wins the claim or if the matter is ultimately compromised with him receiving a part of the estate, this payment is received tax free as a legacy.

> *Lyeth v. Hoey,* 305 U. S. 188, 83 L. Ed. 119, 59 Sup. Ct. 155 (1938);
>
> *U. S. v. Gavin,* 159 F. (2d) 613 (C. C. A. 9th, 1947).

These cases have specifically rejected the argument that the receipts of the heir are income because they are realized as the result of his "bargaining position." In so doing, they have stressed the fact that it is the "heirship which underlies the entire compromise," just as in the instant case it is the running of the Statute of Limitations which underlies the succesful litigation.

These will contest cases cannot be reconciled with the Tax Court's position in the instant case that the successful litigation of the Statute of Limtiations question created the $400,000 increase in net assets. There is also another large body of law clearly contrary to this position. This has been developed in cases in which railroads and other organizations in dealing with their customers and employees have either overcharged the customers or underpaid the employees. It is uniformly held that, when a certain period of time expires and the customer or employee does not make a claim for the amount due, said

amount must be included in the taxable income of the debtor corporation. The increase in net assets resulting under such circumstances is properly treated as taxable income for the following reasons, none of which is present in the instant case:

(1) The failure of the employee or customer to claim the amounts results purely from his neglect and in no sense from a donative intention toward the debtor corporation or its stockholders.

(2) The items arise in business transactions between the obligor and its customers or employees and merely represent adjustments in the consideration furnished by the various parties. That is, the transactions involve considerations on both sides and the questioned amounts merely affect the amount of the consideration.

(3) The transactions are commonly experienced in the businesses involved and constitute a regular flow of benefits to the obligor corporation which are so constant that it in a sense relies upon them as the source of its income.

(4) The items involve mere adjustments in previous accounting entries affecting operations and income rather than capital. Thus, the subsequent adjustment should be reflected likewise. For example, in the case of accumulated wages, these wages have previously been deducted as expenses on the corporation's books. Obviously, when that liability is eliminated the correction should increase income.

While in an early case it was held that the income so arising should be accounted for in the year when the Statute of Limitations ran on the claim against the obligor, *Great Northern Railway Company v. Lynch,* 292 Fed. 903 (D. C. Minn. 1921), the later cases have held that

the year of expiration of the Statute is not necessarily controlling.

*G. M. Standifer Construction Corporation,* 30 B. T. A. 184 (1934). If after a reasonable period expires without the filing of a claim, the Company credits the amount to its profit and loss, this is the proper year for including the amount in income regardless of whether or not the Statute has run at that time.

> *Chicago Rock Island and Pacific Railway v. Commissioner,* 47 F. (2d) 990 (C. C. A. 7th, 1931);
>
> *Charleston and W. C. Railway v. Burnet,* 50 F. (2d) 342 (D. C. App. 1931).

However, the taxpayer may not wait an unreasonable length of time to enter the credits, and, if he does, the Commissioner may treat the items as income prior to their having been reflected as such on the taxpayer's books.

> *North American Coal Corporation v. Commissioner,* 97 F. (2d) 325 (C. C. A. 6th, 1938).

These cases unanimously support two fundamental propositions:

(1) Under no circumstances is it necessary or even proper to wait for a suit upon the obligation and the successful defense of the Statute of Limitations before giving tax cognizance to the elimination of the liability.

(2) The debtor's action in eliminating the liability and crediting the appropriate surplus account is conclusive unless it is too late. It has never been held to be too early, and it could not possibly be held to be too early in a case such as the present one when the entry in 1924 was made long after the Statute of Limitations had run.

Because of the differences between these cases and the instant one outlined above and more fully discussed hereafter, the circumstances of the instant case would not warrant the reflection of the increase in net assets here involved as a taxable income item. But these differences strengthen rather than lessen the force of the above authorities on the question of the appropriate time at which the elimination should be given that tax cognizance which the circumstances require. In the instant case, at the time the corporation transferred the amount to paid-in surplus, there was greater certainty of the finality of its action than in any of the cases above cited. This, because such action in the instant case represented not only the decision of the obligor, after the Statute had run, but also, the decision of the obligee, since she had stated she did not intend to collect, and since the controlling officers of the obligor were, as residuary legatees, the beneficial owners of the interest of the obligee in the obligation after her death. Therefore, the applicable authorities unanimously require that the increase in net assets presently involved should be given tax cognizance in any event not later than 1924. At that time the litigation had not even been commenced. Obviously, therefore, it cannot affect the tax character of the transaction nor constitute a consideration for something already a closed transaction for tax purposes.

Again, suppose in the instant case there had been no action in the Superior Court of Los Angeles County on the note. Would the Government say that because of this, its elimination as a liability on the books of the corporation was erroneous, and that even today for tax purposes the note must be treated as a liability of the corporation? The question answers itself. Consequently, the litigation

thought to be the source of the benefit by the Tax Court does not even satisfy the elemental and requisite "but-for" rule which we know in the field of Tort law, for even if it had not occurred the result would have been the same.

Finally, the Tax Court's view in this regard is completely contrary to the opinion of Judge McCormick in the Estate Tax litigation above referred to. If the litigation in the Los Angeles Superior Court created the increase in net assets presently involved, then, prior to that time, there must have existed an obligation on the note and a correlative right. This right must have had a value at the date of death which was several years prior to the litigation. Yet the Federal District Court in the Estate Tax case held that because of the expiration of the Statute of Limitations no valuable right existed *at the date of death.*

It is respectfully submitted, therefore, that in view of the above authorities, the conclusion is inescapable that the litigation in which the Statute of Limitations was successfully pleaded constituted neither a generating source of the increase in net assets nor a consideration therefor, and, the I. N. Van Nuys Building Company furnished no consideration whatsoever for said increase. This alone is sufficient under the rule of *Helvering v. American Dental Company,* 318 U. S. 322, 87 L. Ed. 785, 63 Sup. Ct. 577 (1943) (discussed more fully hereinafter) to constitute the transaction a gift for tax purposes. But in the instant case the Appellant's case is much stronger than this. We have thus far considered merely the position of the obligor. Let us now examine the facts with reference to the obligee.

The Tax Court has found as a fact that the note "was not surrendered to the Building Company by her (Susanna

H. Van Nuys) during her lifetime nor cancelled, nor the indebtedness represented thereby gratuitously forgiven by her." [R. 23.] This finding is absolutely correct since both of the verbs there used, "cancelled" and "forgiven," connote overt action. The note was not marked cancelled, it was not destroyed, it was not delivered to the maker, there was no written instrument delivered to the maker or to anyone forgiving the note, and there was not even any oral *action* of forgiveness operating *in praesentai.* But what of the holder's inaction? Other findings of the Tax Court make it perfectly clear that the inaction of Susanna H. Van Nuys in failing to take any steps to collect or extend the note during her lifetime and in permitting the Statute of Limitations to run without any action to preserve her rights either before or after it ran was prompted by a gratuitous intent towards the Company and its stockholders. These findings are as follows:

1. The note matured in 1916 and no action concerning its complete or partial payment or renewal was ever taken by Susanna H. Van Nuys between that time and the date of her death some seven years later. [R. 23.]

2. At various times throughout this period (the Tax Court language is "as early as 1915 and as late as 1920") [R. 22, 23] Susanna H. Van Nuys told various members of her family that she did not intend to enforce the collection of the note.

3. The corporate obligor was owned entirely by the obligee and her immediate family. [R. 22.]

4. Susanna H. Van Nuys in her Will, which speaks as of her death and is the final evidence of her intention, made mention of many specific pieces of property but made no mention whatsoever of this note. [R. 23.]

The donative intent thus evidenced, and the inactivity pursuant thereto ultimately (we believe when the statute ran, but just when is not important) created rights in the corporate beneficiary just as complete and irrevocable as the ordinary gift completed by delivery—rights just as complete and irrevocable as would have been created by an actual formal cancellation of the indebtedness as a contribution to the capital of the Corporation.

Tax laws are practical, and tax consequences are based upon the substance of transactions. Thus the Gift Tax law is not concerned with niceties of overt action of delivery and the like, but is concerned only with the "shifting of economic interests."

> *Burnet v. Guggenheim,* 288 U. S. 280, 77 L. Ed. 748, 53 Sup. Ct. 369 (1919).

Thereunder, it is clearly settled that a taxable gift may occur as the result of passivity as well as activity.

In *Commissioner v. Allen,* 108 F. (2d) 961 (C. C. A. 3, 1939), a minor had made a gift when there was no gift tax law in effect. After the effective date of the Gift Tax Act the minor attained his majority and the period during which he could disaffirm the gift expired without his having taken any action to disaffirm. It was held that this failure to disaffirm on the part of the minor constituted a taxable gift, the Court saying at page 966:

> "It was the change of legal rights and the shifting of economic benefits that came about with the termination of the minor's power to revoke which Congress was at liberty, under the Constitution, to tax as a transfer effected at that time * * *"

Likewise in *Helvering v. McCormack,* 135 F. (2d) 294 (C. C. A. 2, 1943), a taxable gift was held to have been effected by the failure of a Trustee to exercise his power to withdraw accumulations, the Court saying at page 296:

> "We agree that, in so far as the Trustee had power during 1936 to withdraw the accumulations and refrained from doing so, he at that time made a gift to the child."

Applying the same test of shift of economic interest in the present situation as was applied under the Gift Tax law under the authorities above cited, it is clear that a taxable gift occurred when the Statute of Limtiations ran. At this point, the Corporation acquired the right simply by electing to assert the defense of the Statute of Limitations, to keep the entire $400,000 without any obligation to return it. It thus acquired legal power at its election to eliminate the $400,000 indebtedness. This shift in legal rights certainly amounts to a shift in economic interests.

There is no room in the practical Tax law for the nice legal theory sometimes advanced that the Statute of Limitations affects merely the remedy and not the right, particularly in a case such as the present where the sole stockholders of the corporation were the children of the obligee who would be the legal recipients of the estate upon her death. The Gift Tax could not function adequately at all if such legal magic could prevent such a clear shift of economic interests from constituting a taxable gift. The instant situation has been specifically recognized as a likely setting for a taxable gift. Thus the

House Committee Report on the 1932 Gift Tax law, H. Rep. No. 708, 72nd Congress, 1st Sess. pp. 27, 28, C. B. 1939-1, Part 2, p. 477, states:

> "A transfer by A. to a Corporation owned by his children would constitute a gift to the children."

The Case law supports this rule:

> *Frank B. Thompson,* 42 B. T. A. 121 (1940), (Remanded per Compromise in which tax deficiency substantially reduced C. C. A. 6th 1942, 42-1 U. S. T. C. Par. 10, 166);
>
> *Robert H. Scanlon,* 42 B. T. A. 997 (1940).

It would undoubtedly be applied to the instant facts under the present Gift Tax Law (there was no Federal Gift Tax prior to 1924). Otherwise, a wealthy taxpayer with a large estate to be distributed could, through passive inaction with reference to the Statute of Limitations, shift her entire wealth to her children without incurring any Gift Tax. And, if there is a gift for gift tax purposes, the benefit must be gratuitous for income tax purposes. No reason or principle dictates otherwise.

Finally, what is the effect of the Corporation's continuing to pay interest on the note, after it had outlawed, to December, 1922, the last interest payment date prior to the death of Susanna Van Nuys? Legally, of course, since the statute had run, the Corporation could not have been required to make these interest payments and in that sense they were purely voluntary. The Corporation deducted these payments as interest. Probably they were not properly deductible since the indebtedness referred to in the interest deduction provision of the Internal Revenue Code, Section 23(b) means an "enforceable obligation."

Mertens, "Law of Federal Income Taxation," Vol. 4, Section 26.04, page 544.

The more accurate characterization of these payments would be that they were dividends to Mrs. Van Nuys, or dividends to the children and gifts by them to her. Dividends paid need not be pro-rata according to stock-holding, and the Gift Tax Regulations provide that "a transfer of property by a Corporation to B is a gift to the latter from the stockholders of the Corporation. If B himself is a stockholder, the transfer, not being a distribution from earnings or in liquidation to which B is entitled as a stockholder, is a gift to him from the other stockholders." Reg. 108, Sec. 86.2(a)(1).

However, the classification as interest or dividends under the laws then applicable was not of any great consequence. The normal tax on corporations during the years 1921 and 1922 was 10% and 12½% respectively, whereas, the normal tax for individuals for these years on a taxpayer in the brackets of Susanna H. Van Nuys was 8%. Revenue Act 1921, Section 210(a) and 230. Under the law then in effect dividends, unlike interest, were not subject to normal tax in the hands of the recipient stockholder. Thus, there was little net loss to the Government in characterizing these payments as interest rather than dividends, and probably no attention was given to the matter by the taxpayer or the Commissioner.

The fact that the corporation deducted interest paid on the note after it had outlawed is related directly not to the question at issue in the instant case, but rather to the

question of whether or not Mrs. Van Nuys reported the payments as interest income. There is nothing to indicate otherwise, and, undoubtedly, she did so. The income tax question directly related to the ultimate issue in the instant litigation is whether or not Susanna H. Van Nuys or her estate took a bad debt or loss deduction for income tax purposes for the loss of the $400,000, or whether they were entitled to do so under the Income Tax law. The answer to such question is very clearly in the negative, and the interest payments subsequent to the notes outlawing have no effect on it.

It is firmly established that where an obligee, for personal reasons, makes no attempt to collect on an obligation against a solvent obligor, the obligee may not take any tax deduction as a loss or a bad debt with respect to that obligation.

S. R. 3833, IV-1 C. B. 153 (1925) (The principal stockholder of a corporation holding a note against it permitted the Statute of Limitations to run without collecting on the note. It was held on several alternative grounds that the stockholder was entitled to no bad debt or loss deduction.)

*H. D. Lee Mercantile Company v. Commissioner*, 79 F. (2d) 391 (C. C. A. 10th, 1935). In denying the deduction the Court stated:

> "It is a startling proposition that a taxpayer may, for reasons of his own, decline to enforce a valid claim against a responsible concern and thus assert that he has sustained a business loss which the Government should share. * * * The Statute of

Limitations can not be used to convert a valid claim against a responsible debtor into a deductible loss on a worthless debt. * * *"

*Thom v. Burnet,* 55 F. (2d) 1039 (App. D. C. 1932). In denying a deduction for worthless debts of a son-in-law, the Court said on page 1040:

"But where the taxpayer, because of family ties or personal relations between himself and his debtor, is not willing to enforce a payment of his debt, in whole or in part, he is not thereby entitled to deduct it from his income tax return as worthless."

*Charles C. Mathews,* 8 T. C. No. 156 (1947);

*E. J. Ellisburg,* 9 T. C. 463 (1947);

*C. B. Hayes,* 17 B. T. A. 86 (1929).

It is obvious under these authorities that the family relationship and donative intent involved in the instant case would preclude any income tax deduction to Mrs. Van Nuys or her estate as a result of the loss of this $400,000 asset, regardless of the fact that interest payments were continued for some time after the note had outlawed. In fairness, it must follow that these same fundamental characteristics of the transaction must be given effect in determining the income tax status of the increase on the books of the obligor.

In any event, the most that the payment of interest to the last date prior to the obligee's death can mean—and this is a most extreme supposition in Respondent's favor—is that both Mrs. Van Nuys and the corporation intended

that her gratuitous intent toward it and her children should not be finally effective until her death. What is the significance of such a conclusion? It merely means that the effective date of the gratuity is postponed. Certainly, there is nothing to indicate that Mrs. Van Nuys' gratuitous intent ceased some time between 1920 and the date of her death. On the contrary, the fact that her Will mentioned many assets but made no specific mention of the note is a clear reaffirmance of the continuation to the date of her death of such a gratuitous intent. Can there be any question but that when the Corporation eliminated the liability and credited its paid-in surplus in 1924 this action was perfectly consistent with the donative intent of Mrs. Susanna H. Van Nuys? Obviously not. Can it be said that the obtaining of a judgment to the effect that the Statute of Limitations had run, thwarted her intent? Obviously not. It was perfectly consistent with her donative intent. Thus, the indisputable fact remains that, regardless of the time when for tax purposes the indebtedness is regarded as having been eliminated,—whether in March of 1920, when the debt outlawed, on May 1, 1923, when Susanna H. Van Nuys died, in January, 1924, when the Corporation eliminated the indebtedness, or in November, 1925, when the Los Angeles Superior Court held the Statute barred the indebtedness,—the result was consistent with the donative intent of Susanna H. Van Nuys, whose passivity in permitting the statute to run was the real source of the increase in the Corporation's net assets.

**In Tax Matters, the Law Is Concerned With the Substance of a Transaction, and the Chain of Events Which Resulted in the $400,000 Increase in the Net Assets of the Company Amounted in Substance to a Contribution of That Amount to the Capital of Said Company Either by Susanna Van Nuys or Her Three Children.**

As early as 1918, the Treasury Department promulgated the following regulations (Regulations 45, 1918 and 1920 Edition, Article 51):

> "Forgiveness of indebtedness.—The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. * * *"

This provision was continued *verbatim* in Regulations 62 under the Revenue Act of 1921 and has been contained in each subsequent regulation (slightly modified as to the second example commencing in 1934) down to the present time, the present regulation on this subject being Regulation 111, Section 29.22(a) 13.

The first two sentences of this regulation state a general principle. There then follow three examples which

are intended to explain and illustrate the principle but are obviously not intended to be exclusive. The last example is the situation of a stockholder who gratuitously forgives a debt owed him by his corporation.

The Tax Court in the instant case simply found that there was no gratuitous forgiveness of the indebtedness by the stockholder, Mrs. Van Nuys, and then concluded, without any further discussion, that, because of this, there was no contribution to the corporation's capital. We submit that the instant issue does not admit of such cavalier treatment. Certainly the instant facts more closely resemble the two examples given in this regulation as constituting a gift or contribution to capital than the example given as constituting the receipt of income.

The only proper way to determine whether the present case falls under the principle of this regulation as illustrated by the example of a stockholder gratuitously forgiving his corporation's debt, is to ascertain the reason for the origin of the principle. This reason is very clearly set forth in the opinion of Justice Learned Hand, in the case of *U. S. v. Oregon-Washington R. and Nav. Co.,* 251 Fed. 211 (C. C. A. 2, 1918), which is one of the leading cases on the subject and probably the case upon which the original regulation above quoted was based. In this case, a parent corporation released a debt against its wholly owned subsidiary in the amount of $6,000,000 and it was claimed that this constituted income to the subsidiary within the meaning of the language of the corporate excise tax law of 1909, which tax was

measured by net income. In holding that this action constituted a contribution to capital, as distinguished from the receipt of income, Judge Hand stated (pp. 212 and 213 (emphasis supplied)):

> "However, the tax though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital *i. e.,* wealth industrially employed in permanent form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between *what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself,* and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed.
>
> "Now it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital. The corporation had just commenced its business; the cancellation of the debt was a means of contribution to its capital account, quite as though the money had been contributed by the stockholder only to enhance the value of his stock. The financial relief, so given, will, it is true, be eventually reflected in the income, since the defendant will no longer be entitled under the act to deduct the interest on the debt; but that only brings out more clearly its char-

acter as capital contribution. We regard the difference as precisely equivalent to the difference between the cancellation of a portion of the mortgage bonds and a cancellation of an equal proportion of their coupons. Common usage would, if we are right, unfailingly allocate the first as an increase in capital assets and the second as an increase in income. That, as we view it, is the proper test of the act."

Apparently, in the above case, the parent had actively "released" its debt. This, however, was not the basis of Judge Hand's decision. The basis of the decision was (1) that the benefit to the subsidiary did not result from "the increase or increment from the exercise of some economically productive power of one sort or the other," that is, it furnished no consideration therefor, and (2) that the principal, a capital item, was forgiven, rather than interest, an income item.

The *Oregon-Washington case* above discussed is the forerunner of a series of cases, which unanimously hold that where a stockholder cancels or forgives an indebtedness from his corporation to him for no consideration, the transaction amounts to a contribution to the corporation's capital and does not constitute income to the corporation. *Commissioner v. Auto Strop Safety Razor Company, Inc.,* 74 F. (2d) 226 (C. C. A. 2, 1934); approved by the Supreme Court in *Helvering v. American Dental Company,* 318 U. S. 322 (1943). *American Cigar Company v. Commissioner,* 66 F. (2d) 425 (C. C. A. 2, 1943), certiorari denied 290 U. S. 699, 78 L. Ed. 601, 54 S. Ct. 208 (1933) (Dictum: Actual holding denied bad debt deduction to parent corporation). *Carroll-McCreary Company, Inc. v. Commissioner,* 124 F. (2d) 303 (C. C. A. 2, 1941). Two of the aforesaid cases applied the rule

even where the debt involved was for an unpaid expense item of the debtor corporation which had been deducted for income tax purposes by it in previous years. The Eighth Circuit decision of *Helvering v. Jane Holding Corporation,* 109 F. (2d) 933 (C. C. A. 8, 1940), casts some doubt on these two cases, but that doubt has largely been removed by the later Supreme Court decision on a similar set of facts in the *American Dental Company case,* 318 U. S. 322, 87 L. Ed. 785, 63 S. Ct. 577 (1943).

In this case certain creditors agreed to cancel a part of back interest against a debtor corporation and a lessor creditor agreed to cancel a part of unpaid rent for back years which was owed him by the corporate debtor. The latter had taken both items as deductions for tax purposes in the years when the interest and rent had accrued, and the Commissioner claimed that it realized taxable income when these items were forgiven. In holding to the contrary the Supreme Court said (pp. 330, 331):

> "Gifts, however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously.
>
> *   *   *   *   *   *   *   *
>
> "The Board of Tax Appeals decided that these cancellations were not gifts under sec. 22(b)(3). It was said:
>
> " 'No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the

debts for altruistic reasons or out of pure generosity.'

"With this conclusion we cannot agree. We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Section 22(b)(3) exempts gifts. This does not leave The Tax Court of the United States free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift. The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute."

It is important to note the following contrast in the facts between the instant case and those involved in the *American Dental* decision. (1) In the latter the cancellation was made by creditors who had no donative intent toward the debtor but only a business interest in it. (2) These creditors had no interest in stock in the debtor nor did their immediate families hold any such interest. (3) The debts forgiven were income items in that they represented previously accrued interest and rent and had been deducted by the debtor in previous income tax returns. Notwithstanding these facts, the Supreme Court held that since the debtor in the *American Dental* case had given nothing for the release, that is, furnished no consideration, the cancellation was gratuitous, and, there-

fore, a gift. In fact this was the only respect in which the *American Dental* case satisfied the tests set forth in the *Oregon-Washington* case, *supra.* Surely, if the elimination of the indebtedness in the *American Dental* case was gratuitous the elimination of the indebtedness in the instant case must be so.

In the *American Cigar Company* case, *supra,* the parent had made considerable advances to its subsidiary when the subsidiary was in financial difficulties and there was little hope that the parent would recoup the advances. In denying a bad debt deduction to the parent, the Court said: "The advances were, in reality, contributions to the capital of the Havana Company (the subsidiary) in which the petitioner was a stockholder." The Court cited the *Oregon-Washington* case, *supra.* It will be noted that, in the *American Cigar Company* case, there was no formal cancellation or forgiveness of indebtedness. Rather there was a transaction which, in form, amounted to nothing more than the creation of an indebtedness, which was in substance held to be a contribution to capital. Certainly, the form of the present action is more analagous to the above quoted regulation than was the form of the transaction in the *American Cigar Company* situation. And it is in intra-family relationships such as is involved in the instant case where the courts are most inclined to disregard the form of the transaction and give effect to its substance for tax purposes. The law is summarized thus in Magill, "Taxable Income," (1945 Edition) pp. 434, 435, where in discussing the effect of a transfer of real estate by a widow to her children in exchange for a promised life

annuity of $5,000 per year, the author concludes that such a transaction should be treated as a gift for tax purposes:

> "The preceding chapter affords many instances of decisions by courts that transactions, in the form of contracts for valid consideration, may be treated as gifts for tax purposes, and vice versa. The fact that, in the instant case, the parties were closely related, and the consideration was not in fact adequate, would lead to the conclusion that the widow did not make an annuity contract, but rather a gift, conditioned upon the payment to her of a sum equivalent to the annual income of the farm."

In the present case, the money was contributed to the company at the time of its origin and was used in the erection of the prime capital asset of the corporation. The indebtedness was, in effect, cancelled (see the discussion in Part IVA3 hereinabove, pp 22-37) by Susanna Van Nuys, a stockholder, at the time the statute ran. It was undoubtedly her intention, as well as that of her children who were then the remaining stockholders, that these funds should remain permanently as a part of the capital of the corporation since they were tied up in the building. Of prime importance, the corporation furnished no consideration for the cancellation of the indebtedness.

Thus, the present situation is exactly within the rationale of the *Oregon-Washington* case, which is the cornerstone of the regulation on the subject and the case law which has followed. All of the considerations mentioned in Part IVA3 of this brief, pp. 22-37 apply with equal force

hereto demonstrate that the present situation amounts in substances to a contribution to the capital of the I. N. Van Nuys Building Company.

There are numerous cases involving claimed deductions where a transaction has been held to amount in substance to a contribution to the capital of the corporation although in form it was something entirely different. These decisions have shown no reluctance to regard the substance rather than the form, nor reluctance to apply the rule when only one stockholder was involved and there was in no sense pro rata contributions.

> *Jenkins v. Bitgood,* 101 F. (2d) 17 (C. C. A. 2, 1939). (One stockholder purchased securities from his corporation at a considerable amount in excess of their then market value.)
>
> *In Re Park's Estate,* 58 F. (2d) 965 (C. C. A. 2, 1932).

Surely justice requires that a similar view would be applied from the standpoint of the debtor in the instant case, particularly since the other shareholders were the children of the creditor.

### Contributions to the Capital of a Corporation Do Not Constitute "Earnings or Profits Accumulated."

Since "Capital" is the very antithesis of "earnings or profits" there can be no question as to the soundness of the above proposition. Suffice to say that this circuit has very recently so held. *United National Corporation v. Commissioner,* 143 F. (2d) 580 (C. C. A. 9, 1944).

## In Determining That the Increase in the Net Assets of the I. N. Van Nuys Building Company Under the Instant Circumstances Constituted "Earnings or Profits Accumulated" the Tax Court Committed a Clear Error of Law Which It Is the Duty of This Court to Correct Under Section 1141(C)(1) of the Internal Revenue Code.

Under Section 1141(c) of the Internal Revenue Code, upon a petition to review a decision of the Tax Court, this Court is required "if the decision of the Board is not in accordance with the law, to modify or reverse the decision of the Board, with or without remanding the case for a rehearing, as Justice may require."

In the instant case all of the facts are agreed. The entire argument heretofore appearing in this brief has been based upon the acceptance in full of the Findings of Fact of the Tax Court. The sole question here is one of law, not only because there are no facts in dispute, but also because the question involves the interpretation of a specific provision of the statute which governs the instant case. Furthermore, the Tax Court's decision is contrary to numerous well settled principles of law.

Fortunately, it is not necessary to discuss in detail the ramifications of the *Dobson* case. 320 U. S. 489, 88 L. Ed. 248, 64 S. Ct. 239 (1943). This circuit has recently reversed the Tax Court in deciding that an increase in net assets resulting from a redemption of stock constituted "earnings or profits," saying: "All the facts are agreed. The sole question here is one of law." *United National Corporation v. Commissioner,* 143 F. (2d) 580 (C. C. A. 9, 1944). Furthermore, it is clearly settled that where there is no dispute on the facts, a determination of whether or not an elimination of indebtedness constitutes a gratui-

tous non-taxable item rather than a non-gratuitous income item, is a question of law upon which the Tax Court's decision is not binding. *Helvering v. American Dental Co.,* 318 U. S. 331, 87 L. Ed. 785, 63 S. Ct. 577 (1943), reversing the Tax Court. *Commissioner v. Jacobson,* 164 F. (2d) 594 (C. C. A. 7, 1947), reversing the Tax Court.

Indeed in the *American Dental* case the Tax Court had found as a fact that the cancellation of indebtedness there involved was not gratuitous, but the Supreme Court reversed the finding on the ground that the Tax Court had applied erroneous legal standards, just as it did in the instant case. Thus, were it necessary, the *American Dental* case would permit us in the instant case to argue the soundness of any conclusions of fact that the Tax Court had made bearing on the gratuitous character of the elimination of the indebtedness here present. However, the Findings of Fact of the Tax Court are not broad enough to require us to go to this end in the instant case.

## Conclusion.

The instant case involves a very simple situation. Susanna H. Van Nuys owned $400,000 in cash which was transferred to the I. N. Van Nuys Building Company in return for its note. This money was invested by the Company in a building and the earnings on that building have been included in the company's income and earnings and profits ever since. The beneficial ownership of the $400,000 has been shifted from Susanna H. Van Nuys to her three children. There has been at most a transmission of this capital asset, and "taxable income is not multiplied by the mere transmission of the capital asset producing it." *Magill,* "Taxable Income" (1945), p. 441.

Of course we cannot ignore the corporate entity, nor the fact that the transaction was originally set up as a loan, and we have conceded in our argument that originally a debtor-creditor relationship was created between Susanna H. Van Nuys and the Corporation. However, this merely means that when the capital asset was transmitted—at a later date than otherwise because of the original debtor-creditor relationship—the transmission had a dual character. That is, the corporation, as a separate entity, realized an increase of $400,000 in its net assets and the three children as principal stockholders therein received a corresponding pro rata increase in their net worth through the enhancement in the value of their stock. *But the fact remains that neither the three children nor the corporation has earned this sum.* It was earned some time prior to 1913 at which time it was capital in the hands of Susanna H. Van Nuys.

The principle which controls the present case was determined long ago in 1918 when Learned Hand in the *Oregon-Washington Nav.* case, *supra,* decided that for tax purposes the capital of a corporation was not limited to the original stockholders' contribution classified in form as capital, but embraced an increase in the net assets in a corporation which amounted in substance to a donation by a stockholder of further capital to the venture. The increase was thus not income, and by the same token, was not an earning or a profit. This is as it should be, and Judge Hand's opinion has grown in stature with the years. The most recent pertinent pronouncement of the Supreme Court on the subject in the *American Dental* case not only cites with approval the cases stemming from that early opinion but also extends the principle far beyond the scope of the facts involved in the original case or the facts involved in the present case.

The Tax Court in deciding adverse to the taxpayer in the instant case gave lip service to this principle but held it did not apply because there has been no *formal, active* cancellation of indebtedness; that is, the donation had not been effected in exactly the same way as it had in the prior cases applying the principle. It thus ignored the true meaning of the principle and the *ratio decidendi* of the *Oregon-Washington case* and necessarily held that the principle had been crystallized into a set form, and was forever thus confined. This is a holding exactly opposite not only to the actual decision in that case, but to that bright concept that this thing we call law is something vital, which grows as reason, justice and intelligent statutory interpretation require.

The Tax Court not only committed a clear cut error of law on the ultimate issue, but also committed numerous errors of law on the subsidiary issues. Its decision should be reversed with the mandate that none of the $400,000 increase in net assets presently involved constitutes "earnings or profits accumulated" of the I. N. Van Nuys Building Company.

Respectfully submitted,

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